Dairy 2009
Situation and Outlook

March 2009 Update

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About this report

The Situation & Outlook process is designed to provide the Australian dairy industry and its stakeholders with an overview of the entire industry supply chain – from dairy farm inputs to consumer markets.

This is the latest of three updates released, following the most recent annual Dairy 2008: Situation & Outlook report published in June 2008.

The report has been compiled with input from industry organisations and dairy companies, as well as a range of information sources.

This updated report

Summarises the operating conditions facing the Australian dairy industry supply chain, and ultimately affecting the profitability of dairy farms;

Summarises the highlights from the 2009 National Dairy Farmer Survey; and

Provides a brief overview of the current industry status and the situation and outlook for the key drivers of the Australian dairy industry.

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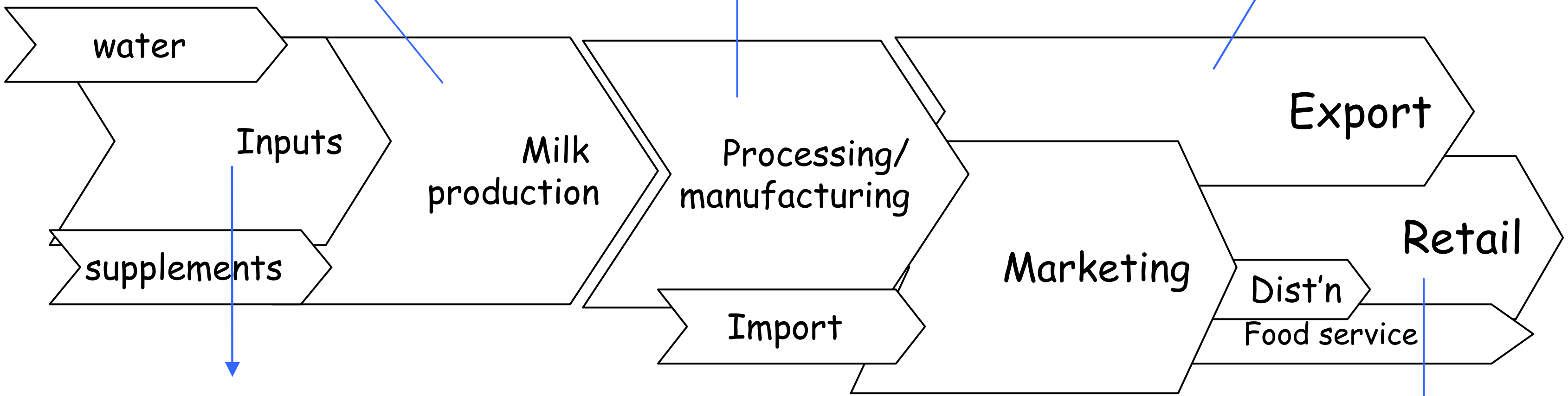
The Six Key Drivers

Australian Dairy Supply Chain

Milk production expectations cut as farmers respond to cashflow challenges by reducing feeding rates and herd numbers.

Exporting manufacturers are balancing the need for conservative approach to 2009-10 opening price against the need to send a positive price signal to farmers.

Commodity prices stabilising as signs of a supply response emerge, and buyers re-enter the market. However, limited scope for price recovery with growing government stocks and export subsidies overhanging the market.



Grain prices likely to be volatile in the short term, but still lower than 2008. Fertiliser and fuel prices falling.
Continued uncertainty over water access.

Domestic market volumes and wholesale prices still holding steady despite consumers continuing to "trade-down"

Key driver outlook

	Global economy	Global demand	Australian market	Global supply	Inputs	Exchange rates
	↓	↓	→	→	↗	→
Major discussion points	World GDP forecast to shrink in 2009, as the financial crisis widens and deepens. Rising unemployment with only a marginal recovery expected by 2010. Government stimulus packages expected to cushion the fall in consumption from second half of 2009. Most Asian economies remain well placed to benefit from stimulus packages. Russia and Eastern European outlook is less positive	International demand will begin to recover at the lower prices prevailing in 2008 Reduced imports into Russia will affect global dairy supply and demand balance – particularly for cheese and butter. Imports likely to recover in China and SE Asia for powders in particular, but Japan to import less cheese. Mixed signals in the EU and US on consumption	General inflation easing, but food prices at top of the range. Wholesale prices for dairy products have held steady, but starting to come under pressure. Trend toward lower priced eating out and takeaway options supporting cheese consumption.	Global supply entering a contraction phase however slow down not enough to improve market balance. EU & US governments to hold over 220,000t of uncommitted SMP by mid 2009 - 20% of world trade. 70,000t of butter is expected to be held in European intervention, representing 7% of world trade. NZ outlook on supply growth impacting market sentiment.	Southern Australia desperately in need of an autumn break – with implications for water availability and purchased feed requirements. Grain prices likely to be volatile over the next three months as world crops enter a critical phase, but potential for lower prices. Fertiliser prices falling in face of increased competition.	AUD forecast range still wide between US 54-77c, A 5 cent shift in exchange rate representing a 2.5c impact at farmgate price. Volatility will continue as markets digest the effects of fiscal stimulus packages. Currencies in some key markets have plummeted against the $US, making dairy imports more expensive now than during 2008. Weaker euro affecting EU offer prices

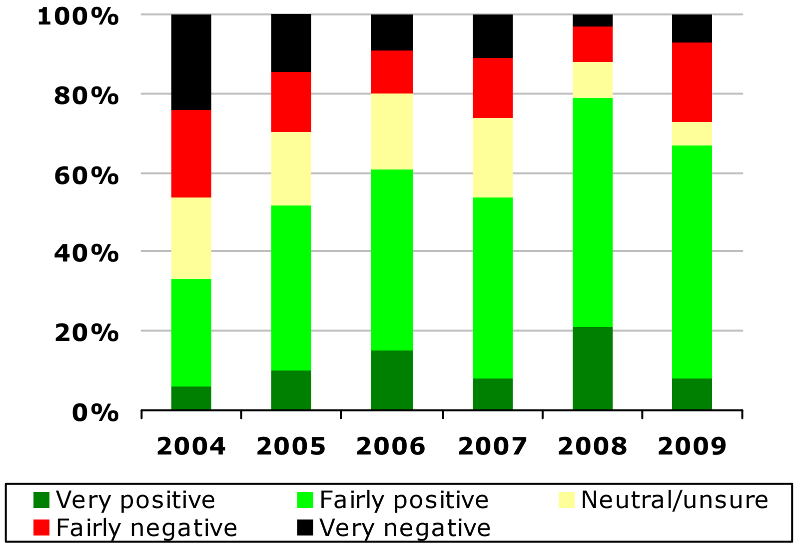
Operating conditions or key driver status:

Positive ↑ Steady → Negative ↓

The Australian dairy industry in March 2009

- The industry situation remains difficult heading into Autumn. As expected, **milk price cuts and an uncertain market outlook have significantly affected farmer confidence and plans**. The reality of the situation has hit this month, as cheques for February milk production have been received.
- **Preliminary results from the 2009 National Dairy Farmer Survey,** conducted in February and early March, indicate **66% of farmers feel positive about the future of the dairy industry, down from 78% in 2008, while very positive responses fell from 21% to 9%.**
- The **76% of surveyed farmers who had experienced a step down** in price, reported both their short and long term plans had been affected. Farmers reported a number of responses to the changed income conditions, primarily **decreasing feeding rates and reducing herd sizes, as well as deferring or extending debt.**

Fig 1: Farmers' attitude to industry future

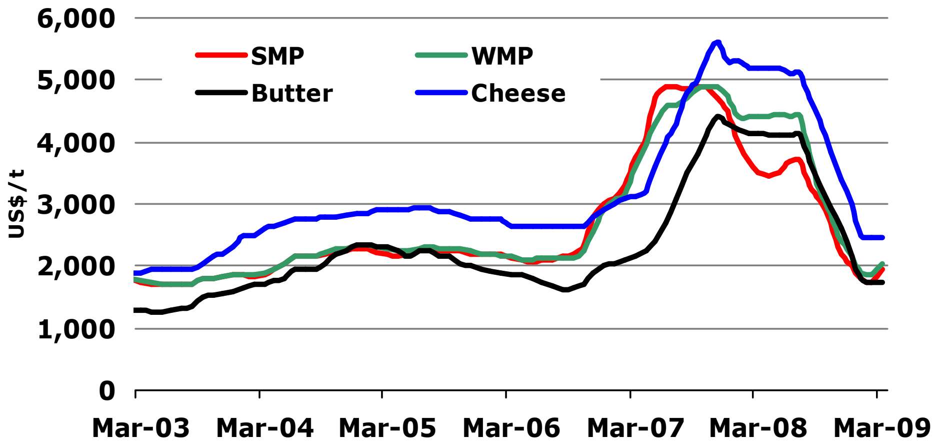


- These production responses, combined with hot and dry conditions earlier in the year, have **led Dairy Australia to cut the 2008-09 milk output forecast to 9.2 billion litres**, the same as last year.
- The downward revision of Australian milk production mirrors **similar moves in the EU and the US, where calendar 2009 production forecasts have been revised down from 1% growth to reduced supply**.
- The lower supply expectations in these two regions is a response to falling farmgate prices. In **Argentina, drought conditions are also likely to see 2009 milk production fall**.
- While a supply response appears to be underway in major exporting regions, the market has been slow to respond, weighed down by export subsidies, and growing government stocks in the US and EU.
- While **stockpiles remain significantly lower than in the earlier part of the decade**, after two years of no stocks the build up has **added to the negative sentiment surrounding international dairy markets**.
- The worsening conditions facing the world's major economies, as well as the easing in demand and supply balance have **transformed the international dairy trade into a "buyers market"**.
- **General uncertainty** surrounding unemployment impacts and consumer responses are making commodity traders and retailers **cautious about making forward commitments**. This, combined with continuing difficulties in financing purchases, have seen **supply pipeline inventories reduced over the opening months of 2009**.
- More recently, there have been **signs that buyers are now re-entering the market, but mainly to fulfill their immediate product requirements rather than long term contracts**.

The Australian dairy industry in March 2009

- Dairy Australia's latest spot price report indicates **stabilising commodity prices**, as exporters report **more product is moving and stock positions – for powders in particular - have improved**.
- As a further positive indicator, prices of WMP sold on Fonterra's *global*DairyTrade increased 16.6% in March, as buyers competed for the limited product on offer.
- While there are encouraging signs, **the scope for a strong and rapid rebound in international dairy prices is limited** while the economic conditions in major importing countries, such as Japan and Russia, continue to deteriorate.
- While **powder and butter prices are likely to stabilise at around US$2000 per tonne over the coming months**, the other key determinant of 2009-10 farmgate prices for the **southern exporting regions will be the exchange rate**. A higher Australian dollar translates directly into a lower farmgate return – approximately **0.5 cent per litre is cut for every 1 cent increase in the dollar**.

Fig 2: Spot export prices March 2003 to March 2009



- There is still a **wide range in current forecasts for the Australian dollar - from 54 to 77 cents** by December 2009. The different forecasts reflect the volatility and uncertainty still surrounding currency markets and the expected impacts of different fiscal stimulus packages.
- Farmers currently dealing with negative cashflows following the step down are viewing the 2009-10 opening price as a trigger point for decision making.
- **While still very uncertain,** current international market conditions suggest a possible farm gate payout in export regions over the full 2009/10 season ranging between $4.00 and $4.60 per kg MS. Below average levels of committed sales in the lead up to July will put **pressure on exporting manufacturers to open conservatively** Firms have to balance the impact of lower milk flows on operating margins against their capacity to offer step-ups as the season progresses. This could see prices open in July between **$3.50 and $4 per kg MS** (or 24-29 c/litre).
- Payments in drinking milk regions will be higher (due to contracts and a stronger domestic market), but new contracts will face downward adjustment pressure.
- **Costs will be a key factor in farmers' ability to manage the reduction in milk returns.** A widespread autumn break and the resultant reduced bought-in feed requirements would provide scope for reducing costs.
- **Input prices are now falling in response to the economic slowdown and market specific factors**. Grain prices, while still volatile remain well below 2008 levels, and have the potential to fall further if the world grain harvest meets expectations and stocks build.
- The next few months loom **as a potential decision point for many farmers,** particularly in Northern Victoria and Riverina. However, the results of this year's survey indicate a **mostly positive long term view of the industry's future**.

The Australian dairy industry in March 2009

Good news

- Global supply is now entering a contractionary phase – with Australia, Latin America and possibly US and EU production slowing.
- Some early signs of buyers re-entering the market, and dairy supply pipelines have nearly cleared.
- Increased import demand from China with lower prices, a post-melamine recovery in consumption (and lower exports).
- Slower economic growth has reduced inflationary pressure on consumers, with further interest rate easing expected in coming months.
- The Australian market is offering steady volumes and returns, as full financial crisis impact and lower international dairy prices have not yet been passed through.

Bad news

- Russia and Japan will import less cheese as their economies contract.
- Consumer and business sentiment stagnating at low levels, and unemployment is expected to rise in key markets.
- Some trade flows still affected by credit and insurance issues.
- Export subsidies likely to be in place for the next 12 months.
- Rising levels of commercial and government stockpiles is weighing on market sentiment.
- Growth in developing economies impeded by financing constraints, lower commodity prices, weak external demand, and the spillover into domestic demand.

Key questions

- How will local companies balance market uncertainties against supply issues in pitching their opening season milk prices?
- How will the prospect of rising unemployment impact consumers' discretionary spending in dairy categories, in particular cheese?
- Will there be a strong NZ supply response following recent price cuts?
- Is the *global*DairyTrade platform a reliable leading price indicator?
- Will the US government buyout of toxic assets succeed in freeing up asset and credit markets and improve confidence?
- Will there be an increase in trade protectionism associated with the fiscal stimulus packages announced around the world?
- Will a depressed Eurozone economy cut demand cause shift in product mix to SMP and benefit from export subsidies and intervention buying? How will the EU dispose of their stocks?

Issues to look out for

- The US and EU are taking a different stance on further fiscal stimulus. Will the continued pump-priming approach of the US be successful and avoid inflationary pitfalls? Will the EU's stance that easing interest rates will be sufficient for credit markets to recover be the correct one?
- Will the US introduce export subsidies in 2009?
- Will the autumn break be sufficiently widespread to relieve pressure on bought in feed requirements, and boost farmer confidence.

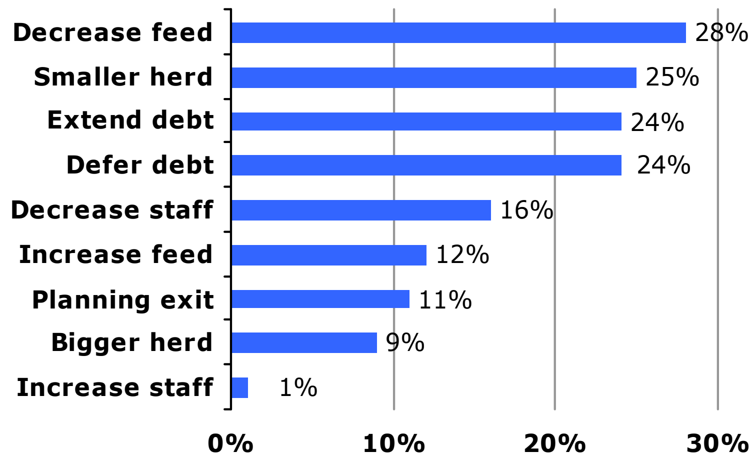
National Dairy Farmer Survey – preliminary results

- During February and March, 1,000 dairy farmers across Australia were interviewed to update their intentions and attitudes. This update presents some key national results, to provide a timely snapshot of current farm sector's status.
- Regional detail will be included in the major annual Situation and Outlook report to be released in June.

Effect of milk price step-down

- **76% of the industry has experienced a "step down" in milk price this year**. Responses to the reduction in milk price for the February to March period included changing herd size, adjustments to supplementary feeding and restructuring debt

Figure 3: Response to milk price step down



- **37% of respondents affected have taken one action in response**, with 10% increasing or restructuring debt, 6% cutting on farm capital investment, 6% reducing supplementary feed rates, and 3% decreasing herd size.
- **42% of those impacted have developed a strategy in response, using more than one option.** Increasing or restructuring debt, as well as de-stocking and/or decreasing staff levels and/or decreasing supplementary feed was most common combination.
- While 5% of respondents de-stocked, and increased the supplementary feed rate for remaining stock, another 5% increased cows and increased feed.
- Overall, the **major change made by farmers was a decrease in the amount of feed used on farm**. This corresponds to a fall in the average rate of feeding grain and concentrates from **1.7 tonnes per cow in 2008, to 1.53 tonnes per cow in 2009**.
- The step down has had a major effect on 57% of farms and a minor effect on 15% of farming enterprises, possibly reflecting differences in calving systems.
- **One in four respondents have reduced their herd size**, which will impact on production over the coming year.
- Respondents who had changed their plans following the price step downs believe the effect will be reversed if input costs fall significantly over the next year.
- 20% of farmers experiencing a step down felt a response wasn't necessary at this stage.

Attitude to the industry's future

- The responses to the question "How do you feel about the future of the dairy respondents industry?" has been used **each year as an indicator of farmer confidence.**
- The **proportion of dairy farmers responding positively to the question fell from a peak of 78% in 2008 to 66% in 2009**.

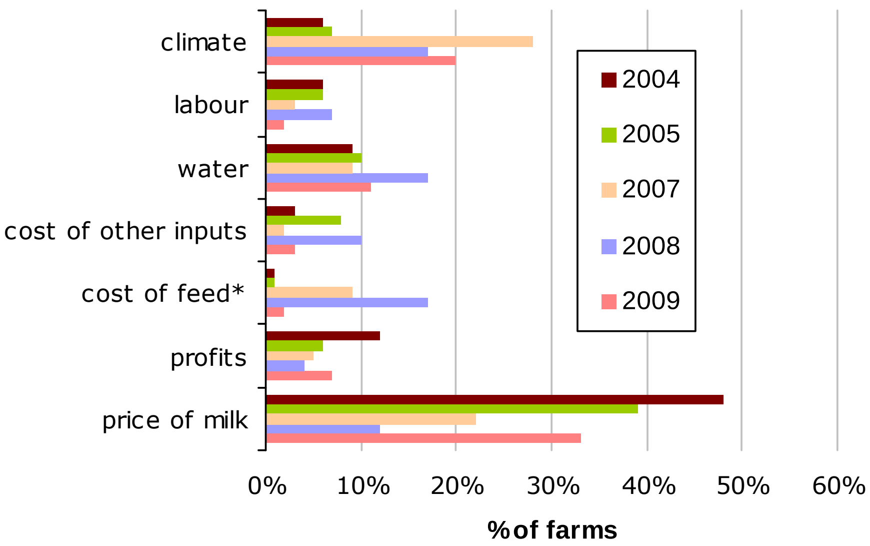
National Dairy Farmer Survey – preliminary results

- Those who felt **very positive** about the industry's future fell from **21% in 2008 to 8%** this year.
- **Negativity is linked to lower milk prices (26%), and drought and water issues (12%).**
- The key reasons for positive outlooks include the belief that there will always be a demand for dairy products (24%), and 7% anticipate an increase in their milk price.
- **Despite the fall, dairy farmers nationally remain more positive than they were between 2004 and 2007.**

Main challenges facing farmers

- **Not surprisingly, milk price has been identified in this survey as the major current challenge for most dairy farmers** (46% up from 8%), ahead of climate (18%), irrigation water availability and price (11%) and the cost of grain and hay (4%).

Fig 4: Greatest future challenge facing farmers



- In comparison, **fewer farmers** (33%) **saw milk price as their major future challenge** as Figure 4 shows.
- 20% of respondents regard climate as the main future challenge, ahead of irrigation water availability and price (11%) and cost of grain and hay (5%)

On farm investment

- While 67% of respondents made on-farm investments over the past 12 months, the proportion planning to spend on investments over the next year has fallen to 32%. Intention to invest was also down compared to 2008 intentions.

Figure 5: On farm capital investment

- 65% of respondents with a price step down made an on-farm investment, compared with 74% of others.
- Investment over the past 12 months has been in machinery (30%), dairy plant (19%), feed systems (16%) and irrigation plant (14%).

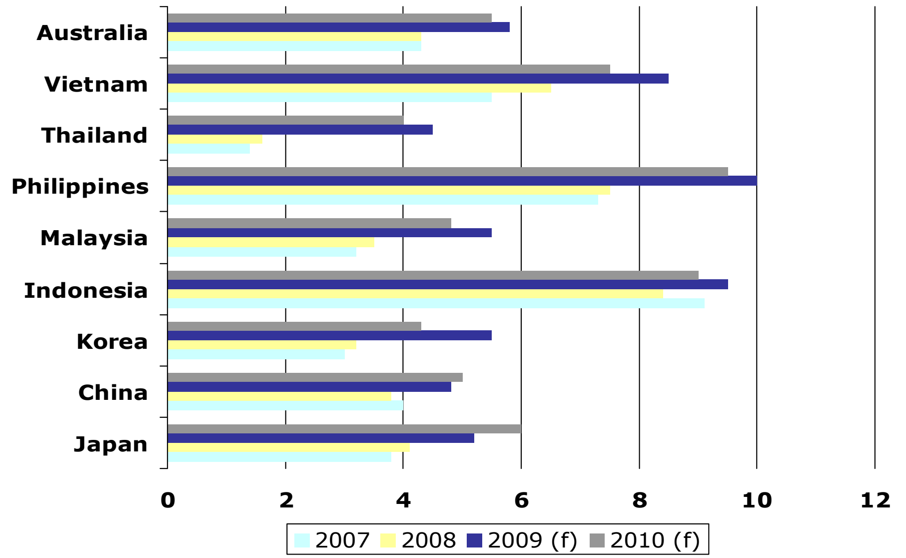
Global economy

- The global economic crisis continues to spread and deepen, resulting in continuing downgrades to growth forecasts. The world's economy now expected to contract in 2009.
- Developing economies were initially shielded from the impact, as their financial systems were less exposed to sub-prime loans.
- However, the effects have now spread throughout the developing world as investors sell foreign assets, and new risk premiums in developing countries (between 6% and 10%) have made borrowing unaffordable.
- The IMF reported that in Q4 2008, global GDP contracted by 5% at an annualised rate, with a **0.5-1% contraction forecast in 2009.**
- The World Bank has stressed there is still a real chance the world will enter a **prolonged recession, particularly if the current financial turmoil intensifies further.**
- IMA Asia expects a **sharp rise in unemployment in key Asian markets in 2009, which will impact on consumption.**

Fig 6: IMF March 2009 projections
Economic growth, % change

	2008	2009	2010
World output	3.2	-0.5 to -1.0	1.5 to 2.5
Advanced economies	0.8	-3.0 to -3.5	0.0 to 0.5
United States	1.1	-2.6	0.2
Euro area	0.9	-3.2	0.1
Japan	-0.7	-5.8	-0.2
Emerging economies	6.1	1.5 to 2.5	3.5 to 4.5

Fig 7: Unemployment rate (%)



Source: IMA ASIA

- Global **crude oil prices are forecast to remain low while there is minimal economic growth**. This should flow on to fuel and fertilizer prices.
- In the US, where the crisis had its genesis, the housing market is beginning to show signs of recovery, leading to a boost in consumer confidence.
- US Federal Reserve expects **a gradual economic recovery to begin towards the end of this year, while the IMF expects the recovery to begin in 2010**.
- Both the World Bank and International Monetary Fund (IMF) believe the **fiscal stimulus packages are a solution to the current crisis**, but have warned that stimulus will need to continue into 2010 to create a sustainable long term recovery.

Global economy

Update on fiscal stimulus packages

- In order to combat a collapse in private demand, various fiscal stimulus packages have been passed, or are in the process of being enacted into legislation.
- The focus of European stimulus packages is primarily on tax cuts and transfers. A €5 billion economic stimulus package has just been signed off by the EU, with up to €1 billion earmarked for farming projects.
- In contrast, Asian economies are focusing on infrastructure. Since the Asia Pacific region is still developing, investment in infrastructure will stimulate its economies, which may in turn lead to a boost in demand for dairy products into the medium term.
- Figure 8 features IMA Asia's assessment of the effectiveness in delivery of fiscal stimulus packages within Asia-Pacific countries, however there will also be spillover impacts within and beyond the region.
- Russia plans to spend $47 billion on stimulating its economy.
- While the packages are generally thought to be a positive for the world's economy, there are concerns regarding how severely these fiscal measures will inflate debt levels and contribute to price inflation, potentially triggering rises in interest rates, which would sap public and business confidence.
- Compounding these concerns are that the economic downturn is also impacting on government finances with share markets in most countries have fallen.
- This reduces government revenues such as capital gains taxes. Taxes on financial sector profits, a significant part of government revenues, have also evaporated. Therefore, the issue of government debt levels is an issue particularly in view of highly competitive credit markets.

Fig 8 : Impact of stimulus packages on Asian-Pacific region

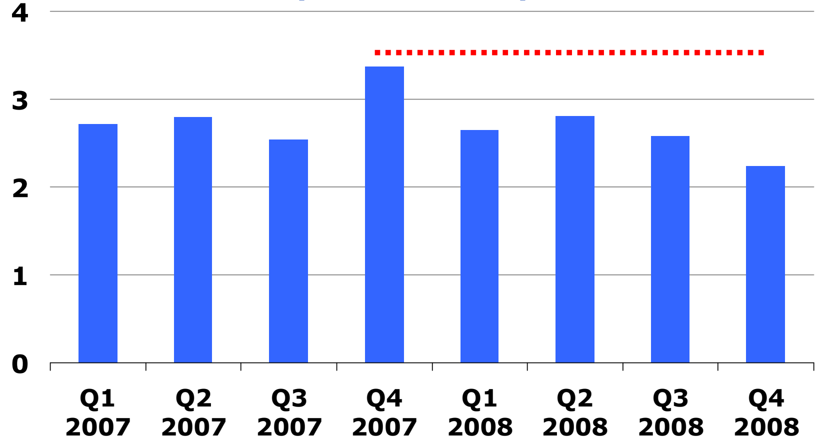
	% of GDP	$US bn	Impact	Comments
Japan	2.4	180	Low	PM Aso blocked in Upper House. Public debt already 180% of GDP
China	13.0	584	High	Beijing can command spending. Low public debt.
Taiwan	4.0	15	Moderate	Pres. Ma in strong political & financial position
Korea	10.0	102	Low	Pres. Lee blocked in legislation, sometimes by his own party.
Indonesia	1.3	6	Moderate	Spending will be driven by 2009 elections.
Malaysia	1.0	2	Low	A 2nd stimulus package soon. Limited by political uncertainty & low oil price.
Philippines	4.0	7	Low	2010 elections will drive spending. Little scope for new debt.
Singapore	7.7	15	High	Massive public savings (>50% of GDP)
Thailand	3.0	9	Low	Political uncertainty has slowed spending.
Vietnam	1.1	1	Low	Large budget deficit. Announced a larger $6bn stimulus – but no details.
India	1.6	17	Low	Most of the stimulus comes from a bigger budget deficit.
Australia	3.6	29	High	Strong fiscal position. Won parliamentary approval.
US	5.5	787	High	Risk that impact will be offset by cuts to spending in highly indebted states.

Source: IMA Asia

Global demand

- The **outlook for global dairy demand remains mixed, with powders likely to fare better than butter and cheese.**
- Some signs of a recovery in global demand are emerging. **Market sentiment remains weak** but with price signals suggesting the market has reached its bottom, opportunistic buying has resumed.
- Global **supply pipelines are still being cleared**. Ingredient buyers are carrying fewer inventories in order to avoid holding volatile-priced dairy ingredients. This approach, combined with financing issues reduced dairy product trade flows in the final quarter of 2008.
- **Strategic buyer activity** will remain a key feature of the current dairy market. Ingredient requirements are being purchased for short-term needs only.
- This situation is likely to continue while market sentiment remains weak, and until signs of a significant price recovery emerge.

Fig 9: World dairy exports - total volume (million tonnes)

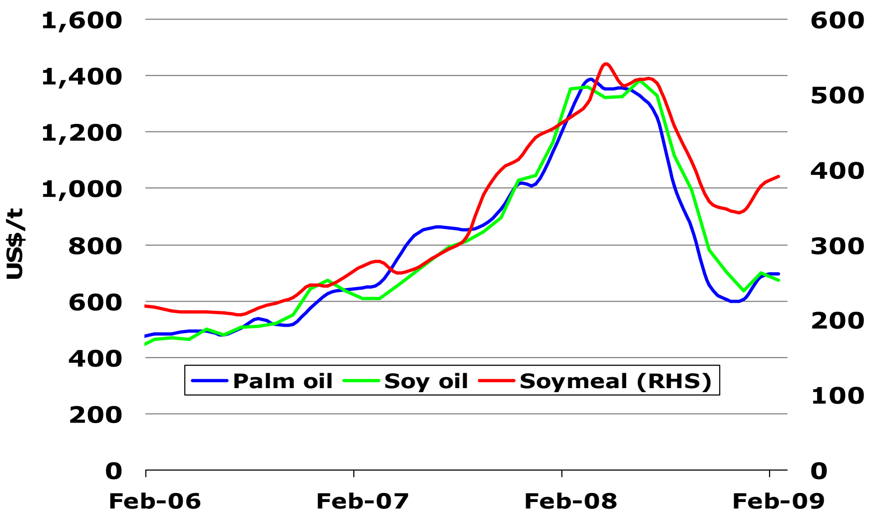


- **The economic downturn and trade finance issues are impacting dairy trade to Russia** – one of the world's largest importers of cheese and butter. Currency realignments have more than offset dairy commodity price falls, making product less affordable, while letters of credit for Russian trade are still difficult to obtain.
- High **cheese inventories in Japan, and commitments to utilize new production facilities, is likely to suppress cheese imports until 2010**.
- The downturn in high-end hotel and restaurant trade in all countries will continue, particularly in Asia and Middle East. Low hotel occupancy rates and reduced tourism and business travel have resulted in lower dairy demand.
- Reduced discretionary spending is evident in some markets and is affecting some impulse buying (eg ice-cream and confectionery and cheese).
- **Growing EU and US inventories will have a negative impact on market sentiment until they are cleared.**
- **Lower prices will drive import demand recovery in some markets in 2009/10**, particularly in Africa, China and Southeast Asia.
- Subsidised government programs in Algeria and Mexico will likely keep dairy import volumes steady in 2009. Both countries are significant since they import large volumes of milk powders.
- There is likely to be **growth of Chinese imports** (post-melamine) of UHT milk, powders, and infant formula in 2009.
- **Recombining activity in South East Asia will provide some import demand growth for milk powders in 2009.**

Competing products

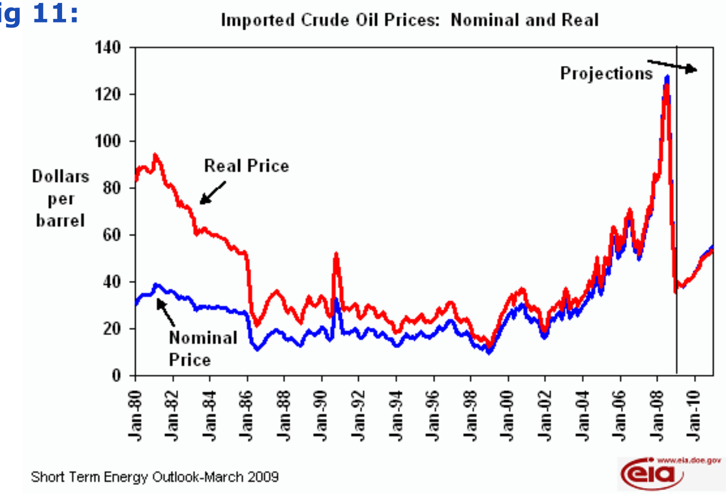
- Prices of oilseeds have now bottomed, and in some instances, have edged up (as figure 10 shows), driven by fundamental supply factors.
- World production of oilseeds is lower than initially expected. In particular, there have been downward revisions of soybean production estimates for South America. World soybean meal production is tipped to fall 2.5% in 2008/09.
- In Argentina, the “February Break” failed to arrive in the growing provinces of Buenos Aires and La Pampa. Approximately 30% of the Argentinean soybean crop is under severe stress from dryness.
- **Tighter supply has been the catalyst for an increase in soy protein prices, which is aiding the competitiveness of dairy proteins.**

Fig 10: Competing fat and protein prices (US$/t)



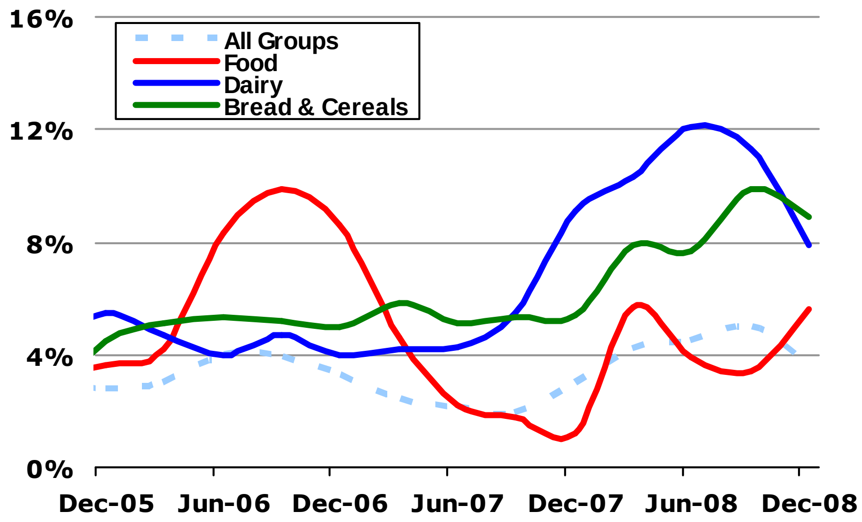
- **Butterfat remains competitive with vegetable oils,** despite vegetable oil price being driven lower by the weakening crude oil market. This indicates there is **limited pressure for substitution away from butterfat**.
- The global economic slowdown is projected to depress energy demand and keep crude oil prices weak for 2009. This will prevent vegetable oil prices from recovering, and **limit the ability of butterfat prices to significantly increase**.
- **Global oilseed prices are likely to remain under pressure** from the global financial crisis. While supply factors have seen the market bottom and prices increase in some cases, crude oil prices will see oilseed prices remain low for the remainder of 2009.
- The annual price of West Texas Intermediate (WTI) crude oil averaged US$100/bl in 2008. The latest Energy Industries Association report projects prices to average US$42/bl in 2009 and US$53/bl in 2010.

Fig 11:



- **The Australian market remains stable in terms of volume and has recorded good value growth in 2008. Retail prices are inherently 'sticky'** in the Australian market, due to the nature of supply contracts between processors and retailers, so there has been no passing on of lower international commodity prices as yet.
- That said, the removal of the 11 cent levy at the end of February saw each of the major retailers reduce drinking milk prices amid a blaze of publicity.
- Consumers have traded down, as retail prices increased, and the gap between branded and housebrand products widened. Nevertheless **drinking milk and dairyspreads volumes have continued to grow steadily**. An initial negative impact on cheese volumes has eased over recent quarters.

Fig 12 – CPI average prices (% change on last yr)



- While **CPI inflation has begun to ease** with a slowing economy, **food inflation continues** at the top of the range. **Dairy price inflation has eased** as the impact of last year's price increases work through the market.
- The **foodservice sector has seen** sales for cafes and restaurants trending downwards, and sales in takeaway and fast food outlets increasing.
- With unemployment still at low levels in Australia, many wage earners are responding to improvements in spending power with easing inflation and the injection of cash from the federal government stimulus packages, **by increasing takeaway purchases. Cheese consumption is likely to be supported by this trend**, as strong growth is being reported in pizza and burger outlets.
- **Wholesale prices have held firm across the range of dairy products**. However, pressure is building as exporters look to re-direct volumes to the more attractive Australian market, and imports continue to play a significant role in the marketplace.
- With the **full effects of the global financial crisis yet to impact the Australian economy**, unemployment and consumer confidence are set to worsen over the next 12 months.
- While a **deteriorating economic situation will impact on the types of product purchased and whether they are consumed at home or while eating out**, the **overall consumption of dairy products is expected to remain stable**.
- Nevertheless, **rising unemployment will encourage continued trading down by consumers**. This, combined with increased competition for local sales is likely to **put retail prices under pressure over the coming year**.

Global supply

Europe

- EU export subsidies were increased for butter and SMP in February. **Despite the larger export subsidies, EU butter and SMP export offer are at the high end of world prices**.
- The European Commission has said the re-introduction of export subsides is a temporary move. However, export **subsides are expected to remain in place for at least 12 months**, budgetary constraints are not an issue.
- **Intervention stores are now open for butter and SMP** in Europe. This has provided an artificial **floor in wholesale prices.**
- **Government stores have filled quickly** with 40,000 tonnes of both SMP and butter sold to intervention stores in the first month. The EU is expected to hold 120,000t of SMP and 70,000t of butter by the end of August when intervention stores close.
- A report from the EC's DG Agriculture and Rural Development predicts that the **EU will not be able to run down the intervention butter stocks until 2012, and SMP stocks until after 2015**.
- While in 2009/10 the EU has a planned 1% increase in milk quota – representing 1.5 million tonnes. The report forecasts that **milk production will actually contract in the short term, with production to fall 0.9% in 2009/10.**
- Importantly, the report suggests that **dairy consumption will grow in 2009, albeit at a slow pace. However, growth forecasts are highly dependent on the Eastern states where the economic downturn is severe, leading some industry groups to label the projections optimistic**.

United States

- The **US is slowly entering a contraction phase**. Extrapolated 50-state output was 14.75 billion lbs, up 0.6%. This was the smallest year-over-year gain since February 2007. **Current USDA forecasts for 2009 have milk production falling 0.8%.**
- Surplus milk powder continues to move to government warehouses. **The USDA has recently revised down forecast purchases for 2009** to 188,000 tonnes (from 260,000 tonnes), driven by projected lower milk volumes, not increased sales.
- Attention remains fixed on **whether the US will decide to implement export subsidies for its stockpiled dairy products**. If so, an annual limit of 68,201 tonnes of SMP exports – representing 7% of world trade - would have the greatest impact on world markets, as allowable volumes for other dairy products are far less significant. In recent weeks there has been a shift in sentiment against initialising export subsidies.
- The USDA has committed 91,000t of government-owned SMP to domestic feeding programs There is **expected to be leakage of these food bartering programs** into commercial channels. Product that finds its way onto export markets will place additional downward pressure on the world price.

Fig 13: US CCC net removals ('000 tonnes)

	2007	2008	2009(f)
SMP	0	49.9	188.2
Butter	0	0	4.5
Cheese	0	0	0

Source: USDA

Global supply

Australia

- o National milk production reached 647 million litres for February – down 3.7%. The eight months to February are up 2.4% on last year, at 7.0 billion litres.
- o **While production this season has been ahead of last year, events over the last couple of months have served to derail continued growth.**
- o These included the **step-downs in farmgate milk prices** in response to falling commodity prices, **extreme temperatures** across the south-east of the continent during January and February and February's **bushfires** in Victoria and **floods** in northern NSW.
- o Dairy Australia recently adjusted downward its **forecast milk production down to 9.2 billion litres for 2008-09** - a similar volume to that achieved last year.
- o **Current conditions indicate 2009-10 milk production could be significantly lower as feeding rates and cow numbers are reduced.**

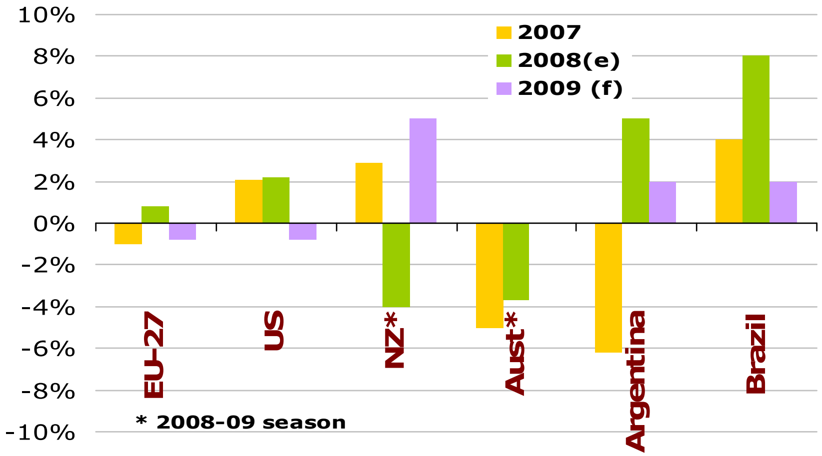
New Zealand

- o Product inventories built up during 2008 are clearing as New Zealand production heads into seasonal lows and buyers re-enter the market. **2008-09 milk production is now forecast to be up 5%.**
- o Milk payout forecasts for 2009-10 range between 30-55% down on current year payouts, but still provide sufficient incentive for farmers to expand.
- o The rate of farm conversions from sheep to dairy will slow, as a direct result of credit issues. However, **milk production forecasts for next season predict growth of anywhere between 2-5%.**
- o Seasonal conditions will play a vital role in milk production, as will further revisions for milk price forecasts.

South America

- o Some parts of South America have experienced **severe drought conditions.** While these conditions have improved recently, the effects will linger.
- o **Cow numbers have been reduced to help cope with drought**, while some feed crops have been severely reduced. Hampered by lower milk prices, milk production growth forecasts have been revised down.
- o **Production growth across the region in 2009 is forecast to be between 0-2%.**
- o There has been a marked deterioration in economic conditions across the region since the last update, however, dairy consumption is still expected to improve this year. Food prices are still affordable, assisted by government intervention in some markets, and inflationary pressures have eased.
- o **Dairy exports from the region will remain steady.** In some instances local market returns are more attractive than those currently being offered on the world market.

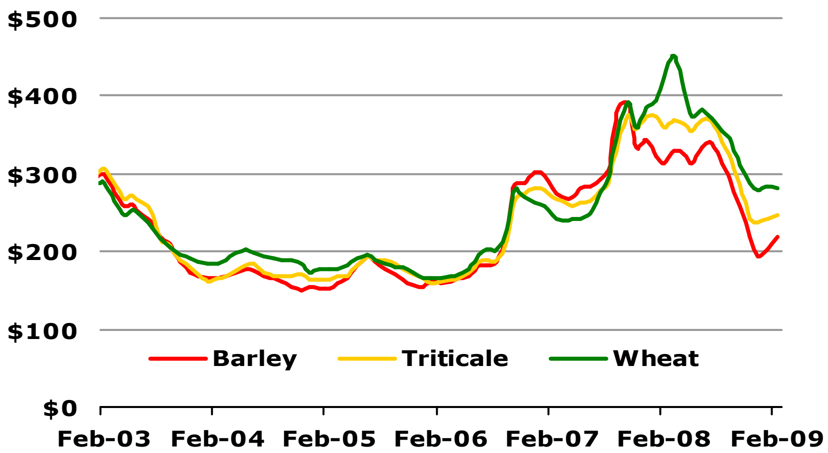
Fig 14: Change in milk production (% chge on last yr)



Feed grains

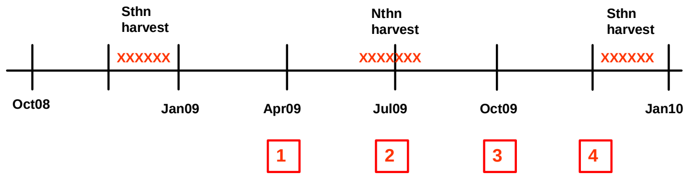
- The **2008/09 winter crop** totalled **32.9m tonnes,** the best in four years and 46% above last year. The **wheat** crop totalled **21.4m tonnes** [up 64%] and **barley** made up **6.8 m tonnes** [+15%], so there is **plenty of grain supply** in Australia, with much still stored on-farm.
- Assuming a timely autumn break, some on-farm stocks may be released to the market in coming months, as growers look to finance next season's crop**. While grain prices are lower this year, falling input costs mean margins are actually better heading into the 2009 season.**
- **Prices have begun to edge up slightly** during March to around $300 / tonne for wheat, and around $225 / tonne for barley, but still remain **well below levels reached last year**.
- **Prices could be quite volatile over the next eight weeks** as predictions of rain spark speculation on the size of both northern and southern hemisphere crops.

Fig 15: Average Feedgrain prices ($ A / tonne)



- **ABARE is forecasting a slightly smaller wheat crop to be planted around the world in 2009,** as a supply response to lower world and local grain prices.
- **Seasonal conditions were favourable last year** in many of the world's major wheat producing regions and **yields reached historical highs**.
- **A return to average yields will result in a fall of 8% in global wheat production to 632 million tonnes.** While **world grain stocks** aren't historically high, they are now **better positioned** than in recent years.
- **March-May is a critical period for global grain crops,** and unfolding weather conditions will determine the size of the 2009 harvest, with resulting implications for stock levels and prices.
- **Assuming 'average' seasonal conditions**, and hence harvests, **around the world** in 2009, prices could potentially be **$50 / tonne lower by end-2009**.

Fig 16: 2009/10 Grain calendar



Hurdles to negotiate:

1. **Mar/Apr/May – Nthn hemisphere spring – US corn/soybean plant – Aust sorghum harvest – Aust cereal plant – silly season**
2. **Jun/Jul – Nthn hemisphere harvest**
3. **Sept/Oct – Aust spring [last 3 failed] – US corn/soybean/wheat spring harvest**
4. **Nthn hemisphere plant – Aust sorghum plant – Aust cereal harvest**

Source: Australian Crop Forecasters

Inputs

Hay

- Farmers across much of the country await the 'autumn break' with great anticipation and expectation.
- There has been a modest start to the season with general rains across the southern regions of Australia. **Follow-up rains will prove to be critical for early pasture growth going into winter.**
- **The Victorian hay market is soft** with prices around $220 / tonne for cereal hay, and pasture hay around $150 / tonne in the state's southern regions.
- While there were no failed Riverina cereal crops baled this year, more fodder appears to have been conserved on-farm, and fewer cows are reducing demand in the north.

Fertiliser

- Although global prices remain very low due to the collapse in oil prices, **local fertiliser prices have been slower to follow** – due to currency movements, high priced stocks and limited competition in some regions.
- Nevertheless fertiliser prices have fallen from their historic highs. With oil prices likely to remain low, fertiliser prices should continue to fall, particularly if new competition enters the market, as has been foreshadowed.

Fig 17: Indicative fertiliser prices ($/t)

	MAP	DAP	Urea
2007	530	530	550
2008	1170	117	650
2009	820	820	580

Source: Australian Crop Forecasters

Water

- **Water trading has increased** by 22% on last year in the 1st qtr of 2009 - but decreased 26% on the six-year average – for a total volume of 22,150 ML at **an average price of $290/ML** – compared with $275/ML at this time last year.
- **Water levels** in the Goulburn-Murray system in northern Victoria have **fallen recently,** after a fairly stable Nov-Jan period. **The total G-M system is at 15% – down from 17% last year.**
- **Allocations will end the season very low** – currently at 32% on the Goulburn and 35% on the Murray – compared with 56% and 41% last year. Northern Victorian water licence holders can now **carryover 50% of their water entitlement** into the 2009/10 irrigation season, an increase from the previously advised limit of 30%.
- GM Water released the **first outlook for 2009/10 allocations** in mid-Feb 09. Inflows have remained well below average for the 3rd consecutive season in all water systems. **The Jul-Nov 09 inflow period will be critical to supporting irrigation allocations next season.**
- **Rainfall outlook** for autumn [Apr-Jun] is for the odds to favour generally average rainfall over the major southern and east coast dairying regions – although slightly lower rainfall is possible in south-east WA.

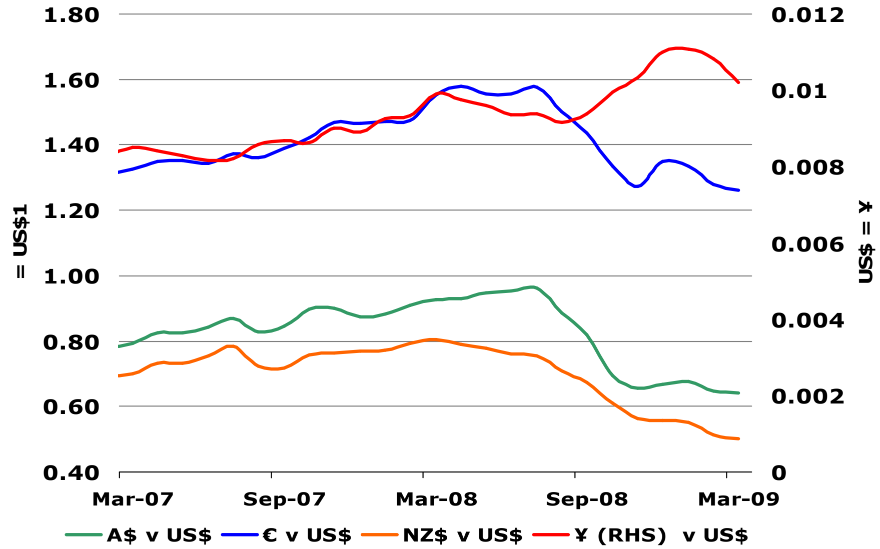
Cows

- After declining for many months, **cull cow sales volumes increased strongly** in early 2009 – up 32% on last year, and up 14% on the six-year average – as farmers chose to offload stock rather than work through the coming months with little feed and much reduced milk prices.
- Prices are similar to last year at 256c/kg. However, per head prices will inevitably be forced lower if there is a sustained increase in supply of cull cows.

Exchange rates

- **Continued volatility in foreign exchange markets is predicted over the next nine months.** The outlook for the Australian dollar remains uncertain, with expectations within a wide range between US 54 and 77 cents by Dec 2009.
- **The severity of the global economic situation have reinforced the "safe haven" status of the US dollar, keeping downward pressure on the Australian dollar**, which has been trading in the US$0.60s, briefly breaking US$0.70s.
- **Lower range exchange rate forecasts** are driven by expectations of prolonged global slowdown and weak Chinese demand for raw materials. **Higher range predictions** are based on effective stimulus packages, and a stabilising global economy.
- The **Euro has weakened against the US dollar lowering EU export offer prices**. Continued weakness will increase the competitiveness of EU exporters.

Fig 18: Exchange rates versus US$



- On the importing side, **some markets are not benefiting from significant falls in global dairy prices due to global currency fluctuations** as figure 19 shows.
- In some countries, **dairy is now more expensive for consumers in local currency terms than it was at the height of the global commodity boom**.
- In **Russia, Mexico and Korea, have been most affected**, while **China has been protected by its currency being pegged against the US dollar**.
- **Exchange rates are expected to stabilise once frozen global credit markets begin to thaw**, but the import affordability index implies demand may suffer in a number of key Australian export markets**.**
- On the other hand, **the appreciation of the Japanese yen has magnified the effect of the commodity price falls in terms of imported prices**.

Fig 19: Import Affordability Index
100 = Feb 2005